United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

75-4197 75-4198

IN THE UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

FRED A. BERZON,

Appellant

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee

GERTRUDE BERZON,

Appellant

v.

COMMISSIONER OF INTERNAL REVENUE

Appellee

ON APPEAL FROM THE DECISIONS
OF THE UNITED STATES TAX COURT

BRIEF FOR THE APPELLEE

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ON APPEAL FROM THE DECISIONS
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BRIEF FOR THE APPELLEE

STATEMENT OF THE ISSUE PRESENTED

Whether the Tax Court properly denied taxpayer[1/] gift tax exclusions for the income interest of shares in a closely held corporation which were transferred by taxpayer into eight separate trusts.

1/ References to "taxpayer" are to Fred A. Berzon. His wife Gertrude is a party to this proceeding solely because she consented to have the gifts involved, which were made by her husband, treated as having been made one-half by her pursuant to the gift-splitting provisions of Section 2513, Internal Revenue Code of 1954 (26 U.S.C.).

STATEMENT OF THE CASE

These are appeals from two actions by taxpayer and his wife seeking redeterminations in the Tax Court of asserted gift tax deficiencies totalling $40,379.10. (R. 15, 33.)[2/] The Tax Court consolidated the two proceedings, filed its reviewed findings of fact and opinion on March 11, 1975, and entered its decisions on June 11, 1975. (R.2,4 .) Notices of appeal were timely filed on August 22, 1975. (R. 109, 111.) Jurisdiction of this Court is invoked under Section 7482 of the Internal Revenue Code of 1954.

In 1958, taxpayer obtained control of The Simons Company, (Simons), a corporation which is in the business of distributing irregular hosiery and pantyhose. The stock of Simons has never been traded publicly nor offered to the public. Simons did not declare or pay dividends during the years in question, nor is there any indication that it has ever done so. (R. 79, 102.)

On September 20, 1962, taxpayer entered into a shareholder's agreement with Joseph Berzon, Phillip Berzon, Harold Berzon, and Norman Shuman, who were the other shareholders of Simons. This agreement forbade any shareholder from disposing of his stock without the express consent of the other shareholders, unless he gave the corporation first refusal. The individual parties to the agreement were to have the next chance to buy the offered shares, should the corporation fail to do so. (R. 80-82.)

2/ "R." references are to the separately bound record appendix.

The agreement further provided that if one of the shareholders succeeded in selling his shares to the corporation, or if one died, his shares would be purchased at book value by the corporation (assuming it had adequate surplus) over a period of 36 months, during which time payment of dividends was forbidden. The agreement made provision for transfers into trusts as follows: (R. 80.)

> FIFTH: No stockholder shall transfer, dispose of or encumber his shares of the stock of the Corporation, without the consent of the other stockholders, except as follows:
>
> 1.) Any of the Stockholders may transfer all or part of his stock of the Corporation by gift to or for the benefit of himself, or any descendant, or any spouse of any descendant. In case of any such transfer, the transferee or transferees shall receive or hold the shares of stock subject to the terms of this agreement and there shall be no further transfer of such shares, except by gift between the individuals specified herein. * * *

Shares held in trust were to be redeemed within 10 years of the agreement's date, with payment at four percent interest within 20 years of the agreement. (R. 81.)

About three months after executing the agreement, taxpayer and his wife created the first of what were to become eight identical trusts, differing only in the names of the beneficiaries, who were the two adult children and the six minor grandchildren of the taxpayer. (R. 83.) Between 1962 and 1968, taxpayer and his wife made transfers of 720 shares of Simons to the

trusts. These shares constituted the entire assets of the trusts during the years in question. (R. 87-88.)

The trust provisions dictated that net income was to be accumulated while a beneficiary was less than 21, after which he would receive the accumulated income (and any principal other than shares of the Simons Co.). Subsequent income was to be paid quarterly to the adult beneficiaries. The trustees were given the power to expend only the income in their discretion for the support and maintenance of a minor beneficiary. They could sell, retain, or otherwise treat with the principal of the trust as they saw fit. (R. 84-85.) However, each of the trust agreements provided as follows: (R. 71, 85)

ARTICLE III
EXPRESS POWER

> Anything to the contrary herein notwithstanding, the Trustees are hereby advised with respect to any shares of stock held by them in THE SIMONS CO., INC. for the trusts herein provided, that such shares of stock are subject to the terms and provisions of a stockholders' agreement made by and among THE SIMONS CO., INC. and the various stockholders thereof and said Trustees are hereby authorized and directed to comply with the terms and provisions of said stockholders' agreement.

The remaining corpus of the trust, that is, the shares of Simons Co. stock, was to be retained in the trust until it terminated, which would occur upon (a) redemption of the shares by the corporation, (b) the passage of 20 years from the date of execution of the trust instrument or (c) the death of the named beneficiary, whichever occurred first.[3/] (R. 99.)

3/ Taxpayer concedes that the corpora of the trusts were gifts of future interest, and do not qualify for the gift tax exclusion.

For their taxable years 1962 through 1968, taxpayers filed gift tax returns, taking annual exclusions of $3,000 for each transfer to each trust. These deductions were based upon an annual determination of the book value of the Simon Co. stock, made pursuant to the shareholders' agreement. (R. 18-19.)

The Commissioner disallowed the claimed exclusions because the gifts were not gifts of present interests. Although the Tax Court assumed without deciding that the gifts of income were transfers of present interests, it agreed with the Commissioner's disallowances because the transfers in question were not reasonably susceptible of valuation. (R. 103,104.) This affirmance had the effect of disallowing the eight annual exclusions claimed by each of the taxpayers for 1965 through 1968, and it increased the aggregate taxable gifts for each taxpayer by $45,000 for the years 1962 through 1964. (R. 94.) The Tax Court's decisions reflected deficiencies in gift taxes from each taxpayer in the amount of $20,189.55 apiece. From these decisions, taxpayers appeal. (R. 109, 111.)

SUMMARY OF ARGUMENT

A donor of gifts into trusts is permitted an exclusion from federal gift taxes of up to $3,000 per beneficiary per year. In order to qualify, the property transferred must be a present interest, that is, one in which the beneficiary may have immediate use, possession and enjoyment. Gifts of future interests -- gifts in which the beneficiary's use or enjoyment is contingent or postponed -- are specifically made ineligible for the gift tax exclusion.

However, gifts into trust for minors may qualify as gifts of present interests even though a trustee has the power to determine when the minor beneficiary will use, possess, or enjoy the property transferred.

In order to qualify as a present interest, the transfer into trust for a minor must meet certain conditions--one of which is that the trust instrument may not substantially restrict the discretion of the trustee to give to the minor as much of the gift as the trustee sees fit, for whatever purpose the trustee deems proper.

In this case, the trusts in question were all subject to a shareholder's agreement which severely restricted the conditions upon which the corpus of the trusts (shares of The Simons Co. Inc.) could either be sold or yield income. The contingencies and prohibitions of the shareholders' agreement made the interest of the adult beneficiaries into future interests, because these strictures postponed and made

uncertain the immediate use, possession or enjoyment of the income interest transferred. The same contingencies and prohibitions also imposed substantial restrictions upon the discretion of the trustees to sell the present unproductive trust corpus and purchase income-productive property in its stead. These restrictions remove the qualifications from the gifts to minors as gifts of present interests. In the case of both the adult and minor beneficiaries, the gift tax exclusion for gifts of a present interest was properly disallowed.

Additionally, even if the transfers in question did constitute gifts of a present interest, they still would not qualify for the annual exclusion. It is settled case law that a transfer into trust which is not susceptible of valuation will not qualify for the $3,000 exclusion. This is true even when the taxpayer resorts to actuarial tables if the circumstances of the case are too speculative for the tables to yield a reasonable valuation.

Here, the past history of the taxpayer-controlled corporation (a history devoid of any dividend payments), when combined with the restrictions upon both the subsequent payment of dividends and the sale of the shares, makes any value for the income from the trust shares too speculative to be valued by using tax tables. Taxpayer's argument that tax tables be used to yield an amount which he could claim for the annual exclusion was, under the circumstances of this case, properly denied.

The decisions below should be affirmed.

ARGUMENT

THE TAX COURT PROPERLY DENIED THE ANNUAL EXCLUSION TO TAXPAYERS FOR THE INCOME INTEREST IN STOCK TRANSFERRED TO EACH OF EIGHT TRUSTS FOR EACH OF THE YEARS IN ISSUE

A. The gifts in issue were gifts of future interests and therefore did not qualify for the annual gift tax exclusion provided by Section 2503 of the Code.

Under Section 2503 of the Internal Revenue Code of 1954, Appendix, infra, the first $3,000 of an otherwise taxable gift to any person during the calendar year is not subject to the federal gift tax. Under Section 2503(b), however, this annual gift tax exclusion is expressly inapplicable to gifts of future interests in property. The term "future interests" includes all interests or estates "which are limited to commence in use, possession or enjoyment at some future date or time." Treasury Regulations on Gift Taxes (1954 Code), §25.2503-3(a), Appendix, infra.[4/] The future interests limitations of Section 2503(b) created substantial difficulties for donors seeking to make gifts to minors in trust or through guardians which would qualify for the gift tax exclusion. In response to this problem, Congress enacted Section 2503(c) as part of the 1954 Code. See S. Rep. No. 1622, 83d Cong., 2d Sess., p. 127 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4760-4761). This section provides as follows:

4/ This Court has recently noted the rule that "Congress permits exclusions only as a matter of grace, and the exclusions sections are to be strictly construed against the taxpayer." Estate of Levine v. Commissioner, 37 A.F.T.R. 2d, par. 148,089 (Dec. 1, 1975).

> (c) <u>Transfer for the Benefit of Minor</u>.-- No part of a gift to an individual who has not attained the age of 21 years on the date of such transfer shall be considered a gift of a future interest in property for purposes of subsection (b) if the property and the income therefrom--
>
> (1) may be expended by, or for the benefit of, the donee before his attaining the age of 21 years, and
>
> (2) will to the extent not so expended--
>
> (A) pass to the donee on his attaining the age of 21 years, and
>
> (B) in the event the donee dies before attaining the age of 21 years, be payable to the estate of the donee or as he may appoint under a general power of appointment as defined in section 2514(c).

Thus, a transfer into a trust for the benefit of a minor will not be construed a future interest if it meets the other requirements, and there is left to the discretion of a trustee the determination of the amounts, if any, of the income or property to be expended for the benefit of the minor and the purpose for which the expenditure is to be made. But this construction as a qualified gift of a present interest will be allowed only "provided there are no substantial restrictions under the terms of the trust instrument on the exercise of such discretion." Treasury Regulations on Gift Taxes (1954 Code), §25.2503-4(b)(1), Appendix, <u>infra.</u>

Addressing the problems of whether an income interest from trust shares constitutes a present interest, the Supreme Court has pointed out that where, in the trust instrument, the beneficiaries' right to the trust income is contingent upon the occurrence of a future event, the income interest is considered a future interest. Fondren v. Commissioner, 324 U.S. 18 (1945). Additionally, if the trust instrument or surrounding circumstances do not assure a steady measurable flow of income to the beneficiaries, there is no basis for finding a present interest. Commissioner v. Disston, 325 U.S. 442 (1945).

It is true that a right to potential future income from trust assets may, under some circumstances, be a present interst subject to gift tax exclusion. But it is settled that an income interest is a future interest if enjoyment is to be deferred, even if only for a short time. For example, in Jardell v. Commissioner, 24 T.C. 652 (1955), a gift of royalty rights under which payments were not to start for about three months was held to be a gift of a future interest. To the same effect, see Braddock v. United States, 33 A.F.T.R. 2d 1394 (N.D. Fla., Nov. 5, 1973); Hessenbruch v. Commissioner, 178 F. 2d 785 (C.A. 3, 1950). Thus, where receipt of income is conditioned upon the happening of some future event, the right to the income is a future interest. See, e.g., Blasdel v. Commissioner, 478 F. 2d 226 (C.A. 5, 1973) (distributions subject to approval by beneficiaries and/or bank's

board of directors). Here, the beneficiaries could not possibly have begun to receive income until the happening of some future event, namely a change in corporate dividend policy or a change in the restrictive provisions of the shareholders' agreement. Accordingly, the gift was clearly a future interest.[5/]

In this case, the shareholder's agreement made receipt of dividend income possible only if there was first a declaration of dividends, while all the shareholders were surviving and while the corporation was not engaged in a buyout of shares. These circumstances existed because, as pointed out above, the shareholders' agreement froze the payment of dividends while the corporation was engaged in the 36-month payoff of a deceased or selling party's shares. Each of the eight trusts was made subject to the shareholders agreement; accordingly, receipt of dividend income by the trusts was dependent upon the contingency that the corporation would not be engaged in the stock purchases mentioned above. This contingency made the putative dividend gift to the adult beneficiaries into a future interest, one which does not qualify

5/ To the extent that the case of Rosen v. Commissioner, 397 F. 2d 245 (C.A. 4, 1968), non acq., 1969-1 Cum. Bull. 225 might be read as holding that there is a present income interest in closely held shares which have no dividend history or potential, it would appear to be incorrect. In any event, Rosen is distinguishable because there (1) the Commissioner conceded that a valuable income interest had been transferred, and (2) the shares could be sold on the American Stock exchange and replaced with income-producing property. Cf. Stark v. Commissioner, 477 F. 2d 121 (C.A. 8, 1973).

for the present gift exclusion, pursuant to Section 2503(b) of the Internal Revenue Code of 1954.

Moreover, the strictures imposed by the shareholder's agreement upon the trust instruments constitute such "substantial restrictions under the terms of the trust instrument" that they also prevent the transfers of alleged income interests to the six minors from qualifying as present interest under Regulations §25.2503-4(b). In the event that the corporation announced the intention of following a no-dividend policy, or that the declaration of dividends were frozen by a corporate purchase of shares, still the trustees under the express terms of the trust instrument would have had the opportunity, provided in the trust instruments, to sell the shares and invest in income-producing property. But the shareholder's agreement vitiates that power by providing that once shares are transferred into trust "there shall be no further transfer of such shares, except by gift between the individuals specified herein." (R. 55, 80.) Cf. Rosen v. Commissioner, 397 F. 2d 245 (C.A. 4, 1968) non acq., 1969-1 Cum.Bull. 225. Additionally, even if the agreement allowed trustees to sell the trust shares, still they could not do so "without the consent of the other shareholders." (R. 55, 80.) These prohibitions constitute substantial restrictions upon the trustee's power to sell the Simons stock and to purchase income-producing assets. As such, the transfers do not qualify for the statutory provision that they deemed present interest, pursuant to Regulations §25.2503-4(b). Thus, because the shareholder's agreement imposes

contingencies upon the right to the adult beneficiaries enjoy the income interest of the stock, and because the same agreement imposes substantial restrictions upon the discretion of the trustees to pay over income to the minor beneficiaries, the income interests do not quality as gifts of present interests, pursuant to Section 2503 and the Regulations promulgated thereto. The gift tax exclusions were properly denied.

B. The exclusion from gift tax was properly denied when the income interests transferred were not reasonably susceptible of valuation.

It is now settled that the use of actuarial tables to determine the value of a gift for a period of years will not be allowed when the questioned gift cannot be reasonably determined thereby. Funkhouser's Trusts v. Commissioner, 275 F. 2d 245 (C.A. 4, 1960); Van Den Wymelenberg v. United States, 397 F. 2d 443 (C.A. 7, 1968), cert. denied, 393 U.S. 953 (1968); Stark v. United States, 477 F. 2d 131 (C.A. 8, 1973).

Taxpayer argues that because the putative income from shares of the Simons Co. could be measured by a term of years, the tables in Regulations §25.2503-5 should be employed. These measure the current value of an income interest at three and one half percent return upon principal. But the use of such tables is justified only when they will have some demonstrated relevance to the matter for which they are used. Thus it may be relevant to compute the time within which a rich divorcee will remarry by reference to a table

based upon the experiences of poor widows. But as Judge Learned Hand points out: "* * * such tables will not be competent, when the circumstances at bar are too far afield from the experience which the tables record and on which their forecasts are made." Commissioner v. Maresi, 156 F. 2d 929, 931 (C.A. 2, 1946).

Such in the case here. In the 15 years between the time the taxpayer took over control of Simons Co. and his case came to trial, (a period which encompassed the years now in question) no dividends were declared. The Tax Court found taxpayer's testimony that he had contemplated declaring dividends unconvincing and self-serving in view of the past history and expansionist policies of the company. (R. 102-103.) Accordingly, the use of actuarial tables to impose a three and one half percent value upon the income from the Simons trust shares is specious. Relevant here are the words of Mr. Justice Black, writing for the Supreme Court in Robinette v. Helvering, 318 U.S. 184, 189 (1943): "Actuarial science may have made great strides in appraising the value of that which seems to be unappraisable, but we have not reason to believe from this record that even the actuarial art could do more than guess at the value here in question."

Taxpayer errs when he argues (Br. 16) that the Tax Court implicitly required him to prove a future payment of dividends. It is contended that there may be a present interest when there is an untrammeled right to trust income, even though the amount

and time of payment is uncertain. But when the donor himself substantially restricts this right, he renders the income interest incapable of valuation and destroys its status as a gift of a present interest. "It is authoritatively settled that a gift upon which the donor imposes such conditions or restrictions is of a future interest." Kieckhefer v. Commissioner, 189 F. 2d 118, 122 (C.A. 7, 1951); Cf. Blasdel v. Commissioner, supra.

Here, the restrictions of the shareholder agreements were specifically imposed by the donor upon the trusts. By making trust income subject not only to an unlikely declaration of dividends but also to the necessities of a concurrent survivorship of shareholders who are not selling their shares, the donor has imposed such contingencies that the income right is not a present interest, and one which is too speculative to be valued by resort to actuarial tables.

Moreover, the prohibition in the shareholders' agreement upon the power of the trustees to sell the trust shares so that they may reinvest in income-producing assets further renders the alleged income interest incapable of valuation.

Accordingly, when taxpayer argues (Br. 35) that there was no "obstacle or impediment" to the income rights of the beneficiaries, he is demonstrably wrong.

Perhaps if there were tax tables whose empirical foundations included tendencies of close corporations to pay dividends after a variable period of not doing so, the taxpayer could rightfully demand their use. But such is

not the case. Even Judge Frank, upon whose language in Commissioner v. Marshall, 125 F. 2d 943 (C.A. 2, 1942), taxpayer rely, pointed out analogous circumstances when the Commissioner should not be bound by the tax table law of averages. Id., pp. 946-947. The present case is another in which there are too many donor-imposed contingencies and prohibitions to allow a reasonable valuation to be made of the income interest in trust shares.

CONCLUSION

The decisions of the Tax Court are correct and should be affirmed.

Respectfully submitted,

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JANUARY, 1976.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has been made on opposing counsel by mailing two copies thereof to each of them on this ____ day of February, 1976, in envelopes, with postage prepaid, properly addressed to them as follows:

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APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 2503. TAXABLE GIFTS.

*   *   *

(b) Exclusions From Gifts.--In the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year 1955 and subsequent calendar years, the first $3,000 of such gifts to such person shall not, for purposes of subsection (a), be included in the total amount of gifts made during such year. Where there has been a transfer to any person of a present interest in property, the possibility that such interest may be diminished by the exercise of a power shall be disregarded in applying this subsection, if no part of such interest will at any time pass to any other person.

*   *   *

Treasury Regulations on Gift Tax (1954 Code) (26 C.F.R.):

§25.2503-3 Future interests in property.

(a) No part of the value of a gift of a future interest may be excluded in determining the total amount of gifts made during the calendar year. "Future interests" is a legal term, and includes reversions, remainders, and other interests or estates, whether vested or contingent, and whether or not supported by a particular interest or estate, which are limited to commence in use, possession or enjoyment at some future date or time. The term has no reference to such contractual rights as exist in a bond, note (though bearing no interest until maturity), or in a policy of life insurance, the obligations of which are to be discharged by payments in the future. But a future interest or interests in such contractual obligations may be created by the limitations contained in a trust or other instrument of transfer use in effecting a gift.

*   *   *

§25.2503-4 <u>Transfer for the benefit of a minor.</u>

* * *

(b) Either a power of appointment exercisable by the donee by will or a power of appointment exercisable by the donee during his lifetime will satisfy the conditions set forth in paragraph (a) (3) of this section. However, if the transfer is to qualify for the exclusion under this section, there must be no restrictions of substance (as distinguished from formal restrictions of the type described in paragraph (g) (4) of §25.2523(e)-1) by the terms of the instrument of transfer on the exercise of the power by the donee. However, if the minor is given a power of appointment exercisable during lifetime or is given a power of appointment exercisable by will, the fact that under the local law a minor is under a disability to exercise an intervivos power or to execute a will does not cause the transfer to fail to satisfy the conditions of section 2503 (c). Further, a transfer doe not fail to satisfy the conditions of section 2503(c) by reason of the mere fact that--

(1) There is left to the discretion of a trustee the determination of the amounts, if any, of the income or property to be expended for the benefit of the minor and the purpose for which the expenditure is to be made, provided there are no substantial restrictions under the terms of the trust instrument on the exercise of such discretion;

* * *